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To: Mr. Gary Jackson, Size Standards Division, U.S. Small
Business Administration

From: The Small Business Technology Coalition

Date: 31 March 2005

Re: **RIN 3245 – AF22**, Small Business Size Standards: Selected Size Standards
Issues, (Advanced Notice of Proposed Rulemaking)

The Small Business Technology Coalition, the nation's largest organization of small, technology-based companies in diverse fields, herewith comments on the above-captioned Advance Notice of Proposed Rulemaking.

SBTC also serves as the Technology Council of the National Small Business Association (NSBA), the nation's oldest nonprofit advocacy organization for smaller companies. Directly and through affiliated groups like SBTC, NSBA reaches more than 150,000 small and mid-sized companies in all 50 states.

While there are many subjects treated in the Advanced Notice of Proposed Rulemaking, SBTC will focus its comments on the issue of "Participation of Businesses Majority Owned by Venture Capital Companies", which is described at pp. 70201-2 of the *Federal Register* announcement (69 *FR* 232, Friday, December 3, 2004).

SBTC is deeply concerned that the changes sought by some in the venture capital community, and described in the ANPR, would open up the SBIR program to broad access by large businesses, acting through large venture capital companies, and that this would prove detrimental to many SBIR companies, and to the SBIR program as a whole.

The current framework

Under longstanding practice, as well as modifications to the SBIR rules made by SBA last December 3 (RIN 3245 - AE76, 69 *FR* 232, Friday, December 3, 2005, pp. 70180-5) venture capital companies of any size may hold minority positions in SBIR companies. Also, venture capital companies may hold controlling positions in SBIR companies, as long as the combined companies (including all subsidiaries and affiliates) are small by SBA standards and the venture capital companies are owned by individuals rather than other companies or institutions.



SBTC believes that this framework provides ample opportunity for VC's of all sizes to participate in the growth of small technology-based firms in the SBIR Program, and for smaller VC's to control and guide those companies.

The ANPR issues

At stake in this Proposed Rulemaking would be the following major changes:

- 1) whether to allow venture capital companies that are *large* by SBA standards, and/or are owned by companies or institutions, to control SBIR companies, and
- 2) whether SBA's affiliation rules will be waived for the first time in the fifty year history of the agency.

Specifically, the ANPR asks whether allowing unlimited VC access to the control of SBIR companies would:

- Shift the program toward lower-risk technologies that are closer to the market
- Increase the geographic concentration of the program (in states like California and Massachusetts, where VC's are most active)
- Change the profile of successful and unsuccessful SBIR companies
- Lead to calls for a further change in the SBIR rules -- allowing large institutions like universities to own SBIR companies, and/or
- Shift the profile of the SBIR program more toward multiple repeat award winners.

SBTC Views

SBTC believes that allowing large VC's and other institutions to control companies in the SBIR program would indeed have each of the above effects.

To set a bit of the context here, it helps to understand the differences between small and large technology businesses in the U.S. economy. Historically, larger U.S. technology businesses have tended to create *process* innovations that strengthen economic efficiency. Smaller technology businesses and independent entrepreneurs have been responsible for the lion's share of *product* innovations that create new businesses and industries.¹ Technological developments that appear likely to play a central role in future US economic growth, such as biotechnology, nanotechnology, homeland security technology, and breakthrough innovations in information technology, have been closely linked to smaller companies. This is an unusual feature of the American economy.²

The SBIR Program targets this crucial small business role in the innovation process, directing some of its creative energy toward the federal government's own R&D needs.

To accomplish this objective, the SBIR Program had to wall off a small fraction of the federal government's R&D contract awards³ from the institutions that have historically dominated those awards: large companies and universities.

Through the use of open solicitations, competitive bidding and peer review, the SBIR Program has used this financial reserve to deliver on its promise. Assessments from the U.S. Government Accountability Office, the National Academy of Sciences, and the National Academy of Engineering, among other reviewers, have uniformly praised the Program for its remarkable speed and cost-effectiveness in pioneering technological innovations.

A notable recent account of the Program's achievements came from an unexpected source. A few months after the September 11th terrorist attacks, the Senate Small Business Committee asked an array of federal agencies to list and explain homeland security innovations that had been developed by small businesses. Once this compendium was completed and reviewed, the Committee was advised by Counsel not to release it to the public: it offered a near-roadmap to the nation's current technological capabilities for combating terrorism. Virtually every innovation in the report, according to those who reviewed it, came from the SBIR Program.

While any program can be improved, not every change is an improvement. Proposals to alter the SBIR Program must take careful account of the factors upon which the Program's success critically depends.

In deciding whether to allow large venture capital companies to control SBIR firms, one must assess whether there is an inherent friction between the federal R&D needs that are addressed through the SBIR Program and the standard operating principles of large venture capital companies.

SBTC believes that there is.

Venture capital companies operate according to relatively settled business models that accentuate rapid, high-double-or-triple-digit percentage paybacks. This approach fits technologies that are lower-risk, have large numbers of potential customers, and are nearing commercialization. It rarely fits technologies in the early conceptual and design phases (equivalent to Phases I and II of the SBIR Program) or technologies with fewer potential customers and larger downstream risks. In many situations, however, the technological gaps that federal agencies are trying to fill through the SBIR Program are inherently "narrow" and "risky". The only "customer" may be the federal government itself. Consider defense technology innovations, the largest component of the SBIR Program by dollar value. Venture investments have been rare in these technologies because they are "exotic" and likely to have a single buyer (the Department of Defense). Similarly, major pharmaceutical companies have tended to invest in "blockbuster" biotechnologies aimed at large markets rather than diagnostics, research tools, unusual illnesses or "orphan diseases".

It is not quite clear why some in the venture capital community feel that large VC's need more access to the federal R&D dollars in the SBIR Program. Venture firms had more than \$84 billion in uninvested funds in 2003, according to the September 29,

2003 issue of *Business Week*. And SBIR represents only a tiny fraction of federal R&D spending by the largest federal agencies. Large VC's should have access to the remaining 95%+ of federal R&D spending through their other investments and relationships.

If, nevertheless, large VC's and the dollars they represent begin flowing into the SBIR Program, the Program will inevitably be transformed. By definition, large VC's will have greater resources to devote to winning SBIR contract awards than will smaller technology companies, even smaller companies backed by small VC's.

SBIR applicants that are backed by companies with millions – or billions – of dollars in revenue, and hundreds – or thousands – of employees, can logically be expected to produce far larger quantities of far more polished applications than truly small companies. Moreover, larger companies can invest far more time and effort in developing relationships with the contracting agencies, officials and program managers. In time, this could very well shift agency SBIR solicitations further and further toward the preferences and capabilities of the larger companies.

Venture capital companies unquestionably play a vital role in the world of small technology companies. Congress explicitly recognized this role by creating, and gradually refining over more than twenty years, Phase III of the SBIR Program. Most SBIR companies view VC's as appropriate and welcome partners in Phase III.

But Phases I and II are fundamentally different. These Phases represent more of the raw inventiveness and creativity that Congress was trying to apply to federal R&D problems through the SBIR Program.

Until now, SBA has rightfully excluded large VC's from *controlling* the small companies that are at this early stage of innovating. But the agency does allow VC's of any size to *participate* in early-stage technologies by holding minority stakes in the SBIR companies developing them. This is an eminently sensible compromise.

SBTC members strongly believe that large VC's should not be in a position to scoop up the scarce federal R&D dollars for early-stage conceptual and development work by small companies, or to dictate how those dollars will be spent. Large companies, including VC's, should focus instead on the other 97½% of federal R&D contracting.

Allowing large VC's to control SBIR companies also would be likely to further concentrate SBIR awards in states like California and Massachusetts, where the VC's are most active, while draining awards away from other states. Venture capital statistics show a decided tilt in VC funding toward areas where the VC's themselves are clustered. States in the Mountain West, among other areas, sometimes go for years without a single VC investment being made. Other states receive only a tiny fraction of the VC investments accorded to the top three or four states. Yet technology-based companies are found throughout the nation. Congress has shown that it wanted the SBIR program to harvest useful technologies from all areas of the country. That is the purpose and focus of the Federal and State Technology (FAST) Program as well as the Rural Outreach Program (ROP), to mention two examples. SBA should not undermine such programs by creating conditions that make it far more difficult for them to succeed.

Which companies will succeed or fail if large venture capital companies enter the SBIR program? For part of the answer we can turn to a letter sent to members of

Congress by the Coalition of Biotechnology Entrepreneurs, and shared with SBTC. They wrote:

“Venture capital investment in biotechnology—particularly over the last five years—has mainly been directed to a small number of companies engaged in relatively low-risk, late stage development of pharmaceuticals that address only the largest markets. Companies focused in fields such as vaccine development, gene therapy, bioinformatics, agbiotech, diagnostics, personalized medicine, biodefense, treatments for orphan diseases, research tools -- as well as high-risk or early stage technology development of any type -- have had virtually no access to institutional venture capital during this period. Clearly advancement of these and other technologies is critical from a public health and national security standpoint. When it does occur, first round biotech investing has concentrated heavily in those regions with a large base of life science oriented venture capitalists, such as the San Francisco and Boston regions. Thus, the SBIR program has and will continue to play an essential role in the survival and growth of early stage biotech companies especially those in markets not being served by the VC community.

Companies that are majority owned by venture capital firms that are controlled by large corporations or pension funds are not small businesses. These companies, though a critical part of the biotech industry, usually do not maintain a small company culture and lack the freedom to pursue technologies and markets that their large company owners do not want pursued. Thus these are not the type of companies that the SBIR program was created to support.”

In other words, VC’s have preferences about the research focuses of the technology companies in which they invest. Large VC’s in the SBIR program will drive companies and technologies in the direction of these preferences. SBIR companies that fit the preferred VC profiles are likely to be the winners in this transformation; those that don’t, the losers. The more prominent the VC presence and cash flow becomes, the more pronounced this shift is likely to become.

And VC’s themselves are only the beginning.

Corporations like the Bank of America and Intel already operate their own venture capital companies. Not only would such “corporate” VC’s enter the SBIR Program if SBA’s affiliation rules are changed, but the incentive for other corporations to create more such VC’s would dramatically increase. Corporations like IBM, Boeing, Lockheed Martin, Genetech, and the large pharmaceutical firms could be expected to form venture capital companies for this explicit purpose. Soon SBIR companies would be competing, in effect, with Fortune 500 corporations for the small SBIR share (2½%) of federal R&D dollars.

It would be unlikely to end there, either. Once such large corporations have broken through the legal framework that has kept them out of the SBIR Program, there would be no equitable argument for keeping universities and other large research institutions from participating in the program via their own VC’s, as well.

Yet the legislative history of the SBIR Program clearly shows that it was developed precisely for the purpose of allocating a share of federal R&D contracts to small business, so that universities and large corporations would not monopolize these contracts.

Stepping a bit further back, if SBA waives its affiliation rules in this situation – for the first time in the fifty-plus year history of the agency and the Small Business Act – it would open up every other small business program in the nation to challenge.

If large companies can force their way into the SBIR Program, why should they be kept out of the SBA's other federal procurement programs, its 7(a) lending program, its Small Business Investment Company program, its surety bond guarantees? Why should SBA's Office of Advocacy continue to distinguish between large and small companies in its efforts to reduce the federal regulatory burden?

The implications of this proposed rule thus transcend the SBIR Program itself, federal R&D contracting, or even overall purchasing practices by the federal government.

At issue is not venture capital company access to the SBIR Program. Small VC's already have broad freedom to participate in the Program, and larger ones can own minority stakes in SBIR companies.

Also not at issue is whether VC's, rather than individuals, can own SBIR companies. While there seems to be continuing confusion on this point, SBA's December 3, 2004 Final Rule clearly permits VC ownership of SBIR companies -- as long as the combined entity, including all subsidiaries and affiliates, remains small, and the VC's in turn are owned by individuals.

The real nub of the issue is whether large businesses can control small businesses and still get SBA to call the combined entities "small".

At heart, this is simply a classic dispute between small business and big business.

What big business seeks in this rulemaking is nothing less than a breach of the single most fundamental principle of federal small business law: that a small business is one which is "independently owned and operated". That was the language used in the Small Business Act over half a century ago, and it is the foundation upon which dozens of subsequent laws, and hundreds of subsequent regulations, are built.

Dissolving this principle by regulation cannot be the vision that Congress and the American people have for the nation's canon of small business laws and protections.

An SBIR Program that pits truly small companies against deep-pocketed fronts for major corporations will not yield the breakthrough inventions by individual inventors, entrepreneurs and small businesses that the federal government has come to depend upon. It will create assembly lines of multiple award winners papering federal agencies with hundreds of proposals, each one a slight mutation on the last.

That is not a future our country needs – or can afford – in a time of global challenge and peril.

SBTC urges SBA to maintain the clear distinction between large and small businesses in access to the SBIR Program.

¹ Zoltan Arcs and David Audretsch, *Innovation and Small Firms*, Cambridge, MA, MIT Press, 1996.

² Richard Nelson, *National Innovation Systems*, Oxford, UK, Oxford University Press, 1993.

³ 2½% of the dollar value of R&D awards by federal agencies whose extramural R&D exceeds \$100 million a year.